of the tier in question. Local authorities may also request that the Commission make the initial "a la carte" decision by means of a petition for declaratory ruling.[274] These provisions for local determination of "a la carte" issues will facilitate local authorities setting rates for the basic service tier while providing for Commission oversight of local decisions that could affect the regulatory status of cable programming services tiers.

200. We will monitor our treatment of collective offerings of "a la carte" channels. If it appears that they are not adequately fulfilling the purposes of the 1992 Cable Act, we will promptly revisit them.

D. Small Systems

1. Small System Administrative Relief

a. Background

201. The Cable Act of 1992 requires the Commission to develop and prescribe cable rate regulations designed "to reduce the administrative burdens and cost of compliance for cable systems with 1,000 or fewer subscribers."[275] In implementing this section, we are guided both by the explicit statutory mandate and by the view that regulatory requirements should generally be no more burdensome than necessary to achieve full compliance. We are particularly concerned about the administrative burdens imposed on small systems, whose more limited revenue base and smaller clerical staff may make them less able to absorb administrative costs.[276]

202. We took a first step at providing administrative relief for small systems when we adopted our current rate

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[274] Filing such a request for declaratory ruling will also toll the time periods in which the local authority must make its decisions. See supra note 273.

[275] Communications Act, Section 623(i), as amended, 47 U.S.C. § 543(i). In our Cost Proceeding we have simplified cost-of-service procedures for small systems. See Report and Order and Further Notice of Proposed Rulemaking, MM Docket No. 93-215, FCC 94-39 (adopted Feb. 22, 1994).

[276] Many small systems, especially independent small systems, serve rural and, often, less affluent Americans. We wish to ensure that our regulatory requirements provide the benefits of the 1992 Cable Act to all portions of the country.

regulations. Specifically, in the Rate Order, we authorized franchising authorities to permit small systems to certify that their rates for basic service and equipment are reasonable under our rate standards, and permitted (and encouraged) franchising authorities regulating the same small system to file joint certifications.[277] We subsequently decided to take a more extensive look at the issue of regulatory relief for small systems, and at the same time stayed the effectiveness of rate regulation for small systems pending our review of the regulatory requirements applicable to them.[278] We sought comment to supplement the record concerning possible additional measures to reduce administrative burdens on small systems.[279] In addition, we asked whether we should differentiate between small systems owned by small multiple system operators ("MSOs") and those owned by larger MSOs when crafting administrative relief.[280]

b. Comments

203. In response to the Rate Order, many petitioners sought reconsideration of our initial effort to grant small systems some form of administrative relief.[281] These petitioners contend that we did not take sufficient steps to ease the burdens of complying with rate regulation for small systems, as we had been directed to do by Congress. To support their claims, petitioners assert that cable rate regulation burdens fall disproportionately on small systems, which are least able to absorb the additional regulatory costs. They claim that small systems do not have the

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[277] See Rate Order, at para. 77. Joint certification is permitted for all communities served by the same system or by different systems; it is not limited to small systems. Id. at paras. 77-78.

[278] Stay Order/Further Notice, 8 FCC Rcd 5585 (1993).

[279] We also sought comment with regard to reducing the regulatory burdens for small cable systems when making cost-of-service showings in the Cost-of-Service Notice, 58 FR at 40773-74. To the extent that comments filed in MM Docket No. 93-215 address the reduction of regulatory burdens on small systems in general, they will be considered herein.

[280] Stay Order/Further Notice, 8 FCC Rcd at 5589.

[281] E.g., Petitions for Reconsideration filed by Coalition of Small System Operators ("Coalition"), Cable Services, and Community Antenna Television Association, Inc. ("CATA").

expertise, nor are they able to afford to hire experts, to prepare the analysis and forms necessary under rate regulation. They also claim that per subscriber costs are higher for small systems, which usually serve less densely populated rural areas and have smaller subscriber bases over which to spread costs. Moreover, they claim that small system operators must deal with more franchise authorities and face higher programming costs. Finally, they contend that revenue sources are limited for small systems. They attribute this financial limitation to the fact that small systems gain a smaller percentage of their revenues from unregulated programming services, such as premium channels and pay-per-view events. They contend that small systems generally do not have the technical ability to provide pay-per-view programming, and assert that advertising revenue is very limited as an alternative revenue source.

204. Most commenters responding to the Stay Order/Further Notice advocate treating small systems affiliated with multiple system operators ("MSOs") the same as independent small systems. These commenters contend that the 1992 Cable Act does not permit different treatment of MSOs and requires that all small systems receive relief from regulatory burdens. Moreover, commenters cite floor debate in the House where a proposal to increase the size of small systems from 500 to 1,000 subscribers was opposed because it would not exclude MSOs from its coverage, but was nevertheless adopted.[282] These commenters further contend that all but the very largest MSOs lack large corporate administrative staffs, centralized data processing, billing, management, engineering and construction support, and volume discounts on programming and equipment.

205. Some commenters claim that regulatory burdens are particularly high on small MSOs, which may have dozens or hundreds of small systems, each subject to separate rate calculations. Moreover, they point out that the regulatory burden of preparing FCC Form 393 and/or a cost-of-service showing is incurred at the franchise level. Thus, they argue, small MSOs which have many small systems serving various franchise areas face regulatory costs equal to, or greater than, independent small systems.

c. Discussion

206. Our rate regulations require systems electing the benchmark approach to setting rates to reduce their September 30, 1992 rates by the 17 percent competitive

[282] See 138 Cong. Rec. H-6525 (daily ed. July 23, 1992).

differential and then adjust the resulting rate forward for inflation, external costs and changes in the number of regulated channels offered by the system.[283] Systems must also establish unbundled equipment charges based on actual costs.[284] Completing our required benchmark forms can impose burdens on small operators, especially the various calculations required to unbundle equipment charges from program charges and set the former at actual cost. The record suggests that it is these equipment computations which impose the most significant burden in the rate-setting process.[285]

207. Our rate requirements are designed to achieve rates for regulated cable service and equipment that will best fulfill the purposes of the Cable Act of 1992. We believe that subscribers of small systems should be able to obtain the benefits of these regulatory requirements to the same extent as subscribers of larger systems. At the same time, it may be more difficult for small systems to comply with these requirements in the same time frame as larger operators. Accordingly, on reconsideration, we are adopting rules in addition to those established in the Rate Order that will provide administrative relief for small systems but that will also, as described below, achieve substantial compliance with rate regulation requirements.

(i) Streamlined Rate Reductions

208. As noted, under our revised benchmark rules, regulated cable systems must establish rates based on September 30, 1992 rates, as reduced by the competitive differential and then adjusted forward by inflation, changes in the number of regulated channels offered, and external costs. Generally speaking, when they become regulated, small systems are subject to these requirements unless they are eligible for transition relief.[286] Such systems must also establish unbundled equipment charges based on actual

[283] See supra paras. 114-115.

[284] See Rate Order at para. 287-88.

[285] National Cable Television Association ("NCTA") Comments at 5-6 (August 31, 1993).

[286] Small systems may be eligible for transition relief -- and not be required to immediately apply the full competitive differential -- either because they are owned by small operators or because they charge relatively low prices. See supra at para. 117-126.

cost.

209. In order to permit small systems to implement competitive rate reductions that will benefit subscribers while reducing administrative burdens, we will permit eligible small systems, as defined below, to reduce their rates under a streamlined approach instead of using the benchmark methodology set forth in FCC Form 1200. Specifically, small systems owned by eligible operators may elect to make rate reductions by reducing each billed item of regulated cable service by the competitive differential in lieu of following our more comprehensive rate regulation rules.[287] Thus, operators may reduce the billed charge for each tier of regulated service by the competitive differential. The reduction will be from charges in effect as of March 31, 1994. The amount of the reduction will be 14 percent, which approximates the amount of the competitive rate reduction that would be applicable to many small systems that have not been regulated and that therefore did not implement any rate reductions under our initial rate regulations.[288]

210. Similarly, under the requirements we are establishing today, small systems electing to reduce rates in this manner must apply the 14 percent reduction to each regulated equipment charge appearing on subscribers' bills. Thus, under this approach, eligible small systems are not

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[287] This relief will be available only to small systems owned by eligible MSOs and independent small systems, as defined below.

[288] This percentage reduction roughly approximates what the required rate reduction would be if the small system were required to reduce its September 30, 1992 rates by the full competitive differential of 17 percent and those rates had then been floated forward to adjust for the three percent inflation that occurred between September 20, 1992 and September 1, 1993. We recognize that a line-item reduction of 14 percent is not as precise a mechanism for setting regulated service and equipment rates as the calculations set forth in FCC Forms 393 and 1200. For example, unlike the rate calculations set forth in Forms 393 and 1200, the simple 14 percent reduction does not accommodate changes in external costs and the number of channels that may have occurred since September 30, 1992. We nevertheless believe that this reduction serves as an appropriate approximation measure of competitive rate reductions that will produce rates that are reasonable for the small system and its subscribers alike while achieving the goal of reducing administrative burdens for small systems.

required to unbundle equipment and installation charges from their programming service charges, or to set equipment and installation charges at actual cost.[289]

211. We believe that these rate reductions will be easy to implement in that they merely involve application of a percentage reduction to each billable charge rather than the more extensive calculations set forth in FCC Form 1200. At the same time, the reductions will ensure that the subscribers of small systems pay reasonable regulated rates.

212. However, as stated, we believe that small systems ultimately can and should establish regulated rates on the same basis as other operators. Thus, this streamlined alternative to implementing rate reductions will be a temporary approach to setting rates prior to full compliance. In our Cost Proceeding, we have decided to examine whether we should establish possible average cost schedules for the provision of equipment, as well as average cost schedules generally for provision of regulated program service.[290] These schedules could be used by small systems to set rates instead of requiring them to identify and evaluate their own costs or make the calculations required under our benchmark rules. Thus, these schedules could afford significant administrative relief for small systems as well as all systems generally.

213. We believe that when average cost schedules for equipment are developed, small systems that have elected to make streamlined rate reductions should be required to develop rates based on September 30, 1992 rates with specified adjustments as required of cable systems generally. This opportunity to implement streamlined rate reductions, subject to full compliance later, will give eligible systems a sufficient opportunity to prepare for compliance while affording consumers significant benefits in

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[289] 47 C.F.R. 76.923. Thus, if a small system electing this option has rates for a basic service tier, an enhanced tier, remote control rental, additional outlet charge and an installation charge, each of these components of the monthly bill would be reduced by 14 percent in lieu of its completing FCC Form 1200 and making the rate calculations required therein.

[290] See Cost Proceeding.

the interim.[291] Thus, we will require small systems that have elected to make streamlined rate reductions to establish rates based on full compliance with our rules at the time we establish average cost schedules for equipment.[292]

214. If a small system elects streamlined rate reductions, the permitted rate for a tier will be the rate for the tier in effect on March 31, 1994 minus 14 percent.[293] The rate will then be capped at that level and the price cap requirements applicable to cable systems generally will govern rates for the tier. Thus, capped rates may be adjusted annually for inflation, quarterly for external costs, and quarterly for additions and deletions of

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[291] Operators will not be subject to refund liability to the extent that rates established during the interim period exceed what would be permitted under regulations applicable to cable operators generally. By the same token, undercharges during this period may not be recovered prospectively from subscribers.

[292] We will specify the time period for compliance in the decision adopting average cost schedules for equipment. The Commission may alternatively require full compliance with our rate regulations at an earlier date if we experience delays in developing average cost schedules for equipment. As indicated, the 1992 Cable Act requires that operators "establish, on the basis of actual cost," the rates charged for equipment and installation. Communications Act Section 623(b)(3), 47 U.S.C. Section 543(b)(3). We believe that the statutory mandate that the Commission reduce administrative burdens on small systems permits the Commission to defer compliance with this provision in order to reduce the administrative burdens of full compliance. Thus, average equipment schedules will permit establishment of rates for equipment based on costs in full compliance with the statute, and deferral of full compliance will reduce administrative burdens. Accordingly, our deferral of unbundling and actual cost requirements is consistent with the statute.

[293] A small system that has violated the rate freeze and subsequently makes a 14 percent streamlined rate reduction from rates established in violation of the freeze, will be required to later adjust rates to account for any overcharges that resulted from the freeze violation. The Commission's stay of rate regulation for small systems does not affect the application of the rate freeze to them. Small systems remain subject to the rate freeze until May 15, 1994.

channels.[294] Small systems must use FCC Form 1211 when justifying such rate changes to local or federal regulators.

215. Our provisions for streamlined rate reductions are intended to provide administrative relief for small systems because small systems are less likely to have the resources to comply with our rate reductions in a timely fashion. On the other hand, some small systems as defined in the 1992 Cable Act may be affiliated with larger companies with the resources to fully comply with our rate requirements. Accordingly, we are establishing standards of eligibility for streamlined rate reductions designed to limit their availability to larger companies.

216. Streamlined rate reductions will only be available to independent small systems (i.e., those that are not owned by or affiliated with other cable systems)[295] and to small systems owned by those MSOs that have 250,000 or fewer total subscribers, own only systems with less than 10,000 subscribers each, and have an average system size of 1,000 or fewer subscribers.[296] The 250,000 subscriber cap

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[294] Rates set under the streamlined rate reduction approach will not be based on average rates across all regulated tiers as is the case for setting initial regulated rates for cable operators generally. However, our price cap requirements, including adjustments for inflation, external costs, and adjustments for changes in regulated channels, will nonetheless be applied to the resulting tier charge.

[295] We do not believe that small system administrative relief should be available to companies that have a significant financial or other relationships with larger companies that would enable them to more readily comply with our rate requirements than would smaller companies. Accordingly, we will limit streamlined rate reductions to those companies that meet our eligibility criteria and that are not affiliated with larger companies. For purposes of measuring affiliation, we will employ the same criteria we use for determining eligibility for transition relief. See supra para. 120. Thus, we will not permit streamlined rate reductions by companies in which a larger company holds more than a 20 percent equity interest (active or passive) or over which a larger company exercises actual working control (such as through a general partnership or majority voting shareholder interest).

[296] Eligibility for streamlined rate reductions will be determined by application of our eligibility criteria to the company as it existed on March 31, 1994. This will eliminate incentives for operators to change affiliation in order to become

ensures that larger MSOs do not benefit from a form of administrative relief that they may not need because they are likely to have the resources necessary to expeditiously establish compliance with rate regulation requirements.[297] The 10,000 and 1,000 subscriber limits help tailor streamlined rate reductions to small systems that are owned by those operators that are most likely to own numerous small systems. The record strongly suggests that it is these operators that face the highest administrative costs of complying with our benchmark regulations because they own so many systems and all of their systems serve fairly small subscriber bases (i.e., none is larger than 10,000 subscribers). Streamlined rate reductions will not be available to any system that has already restructured its rates in an effort to comply with our rules, since such a system has demonstrated that it does not need the administrative relief that the streamlined rates reduction process is intended to provide.

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eligible for streamlined rate reductions.

[297] We estimate that streamlined rate reductions will be available to approximately 4,845 small systems which represent 42 percent of the 11,529 cable systems in the United States. The approximately 1.4 million cable subscribers served by those small systems should ultimately benefit from any cost savings resulting from such relief. These 4,845 small systems include approximately 539 independent small systems serving approximately 200,000 subscribers and 4,306 small systems owned by 508 MSOs meeting our eligibility criteria for streamlined rate reductions. These 4.306 systems serve 1.2 million cable subscribers, representing 39.8 percent of the 10,816 MSO-owned cable systems in the United States and 2.3 percent of the 54.4 million cable subscribers served by MSOs. These data were obtained from the Cable Television Factbook database purchased by the Commission in electronic format. This information is available in printed form in the Cable Television Factbook. The estimate for independent small systems may be slightly overstated due to the Factbook database's inclusion of systems that only distribute broadcast signals which are not jurisdictionally "cable television systems" for purposes of these regulations. The Factbook database indicates that there are 11,529 cable systems in the United States serving approximately 55.9 million cable subscribers. However, we are unable to ascertain from the database whether nine systems (2,642 subscribers) are MSO-owned or independent cable systems. Accordingly, these nine systems and their correlating number of subscribers are not reflected in the number of MSO-owned and independent systems but are included in total systems and total subscribers. The data does not reflect application of our attribution rules.

217. Small systems electing to implement streamlined rate reductions must provide written notice to that effect to their subscribers, as well as to the local franchising authority with respect to the basic service tier and the Commission with respect to a cable programming service tier. This notice must be provided within 30 days after the small system becomes subject to regulation. The small system must then implement the streamlined rate reductions within 30 days after the notification has been provided.

(ii) Company-Wide Averaging of Equipment

218. Under our benchmark rules, operators are required to aggregate expenses and revenues, including equipment and installation costs, at the franchise, system, regional or company level in accordance with the operator's practices as of April 3, 1993.[298] In order to reduce administrative burdens associated with setting unbundled rates for equipment based on actual costs, we are permitting operators of small systems to average the equipment costs of its small systems at any level, or combination of levels, regardless of the operator's practices as of April 3, 1993, subject to safeguards designed to protect subscribers from unusual rate changes.[299] Under this approach, a cable operator of any size may average the equipment costs of all its small systems, or only some of them, for purposes of developing unbundled equipment charges that are set at actual cost. This process will permit operators to select a level of averaging that enables them to develop equipment charges in accordance with our rules, but also involves the least administrative burden. Specifically, it may be less burdensome for some operators to average the equipment costs for their small systems at a level different from the level at which they generally averaged their costs on April 3, 1993. This flexibility therefore should reduce the overall effort and expense involved in separating equipment costs from programming costs when calculating individual small system rates.

[298] See 47 C.F.R. §76.924(d); First Recon. Order, at para. 65, n. 96.

[299] Under this approach, equipment costs would be based on the actual costs experienced by the operator averaged at a level selected by the operator. This rate setting approach is different than setting rates based on average equipment schedules, which would involve setting an individual operator's equipment costs based on average industry costs.

219. We recognize, however, that setting equipment charges at a different level of cost averaging than the operator was employing on April 3, 1993 could involve rate changes both for equipment and programming service charges, since permitted rates for equipment and programming service charges are based on aggregate programming service and equipment charges as of September 30, 1992. In order to prevent sudden rate changes that could harm subscribers, we are establishing several safeguards that operators of small systems must follow when developing average equipment costs for those systems. First, the flexibility in averaging equipment costs will apply only to the operator's small systems, rather than the larger systems it owns. Second, it will only be permitted for equipment, as opposed to installation charges. This is because we believe that equipment charges are less likely to vary significantly between systems, whereas installation charges are more dependent on local labor and other costs that can be quite different in different communities. Third, operators may establish average charges only for similar types of equipment. Thus, for example, average charges may be established only for similar types of remotes or converters. Finally, when justifying equipment charges averaged across the operator's small systems, the operator must present a general description of the averaging methodology employed and a justification that it produces reasonable equipment rates.[300] Based on the showing, local franchising authorities and the Commission may, for good cause, require that the operator set equipment rates in accordance with existing rules. We also note that in the Cost Proceeding, we are soliciting comment on what level of cost averaging we should require or permit operators to employ in setting rates.[301] We may alter in that proceeding the cost averaging approach established today. We will additionally monitor the impact of our action today to assure that it does not harm subscribers.[302]

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[300] Where there is good cause, a franchising authority (or the Commission, where relevant) that believes that the averaging methodology does not produce reasonable equipment rates, may require the operator to set equipment rates based on our current requirements.

[301] See Cost Proceeding.

[302] Section 623(b)(3) of the Communications Act of 1934, 47 U.S.C. § 543(b)(3) requires that equipment charges be based on actual cost. That section does not specify a particular method for determining the actual cost of equipment, or whether equipment costs may be based on average company or industry

220. As indicated, this administrative relief provides a methodology for setting unbundled equipment charges based on actual cost. As such, it will be available to all cable operators owning small systems. We see no reason to limit the eligibility for this small system relief to operators of a certain size. Moreover, this relief is not intended as an interim measure. Rather, operators may set equipment rates based on company-wide average costs subject, as indicated, to any decision on cost averaging the Commission may establish in the Cost Proceeding.

221. We believe that the 1992 Cable Act affords us sufficient discretion to adopt the dual approach described above, which is designed to "reduce administrative burdens and costs of compliance" for all systems that have 1,000 or fewer subscribers. The statute does not mandate that we provide the same level or magnitude of relief to every small system regardless of the resources or affiliation with a large operator. Notably, we have tailored the relief on the basis of our evaluation of the resources and capabilities of different types of small systems. We have balanced the public interest benefits of unbundling equipment and installation charges from programming charges against the administrative burdens on such systems. We find that varying degrees of relief are appropriate for small systems owned by different size operators, although every small system is afforded relief of some kind. Moreover, the fact that some members of Congress unsuccessfully objected to the provision regarding administrative relief for systems with less than 1,000 subscribers because MSO-owned systems would fall within this category, does not demonstrate that Congress intended to limit our flexibility in fashioning appropriate administrative relief. We thus conclude that our dual approach is consistent with the 1992 Cable Act.

(iii) Other Proposals for Administrative Relief

222. Several petitioners, including Arizona Cable Television Association, et al. ("Arizona"), Mountain Cable ("Mountain"), Cable Services, and CATA, advocate complete exemption from rate regulation for all systems that are classified as small systems.[303] As stated in the Rate Order,

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costs. We believe that permitting operators to set equipment charges based on average costs comports with the statutory mandate that equipment charges be based on actual costs.

[303] Arizona Cable Television Association et. al. Petition for Reconsideration at 4; Mountain Cablevision, Inc. Petition for Reconsideration at 2; Cable Services Petition for Reconsideration

"[w]e do not believe that our responsibility under the Cable Act to ensure that consumers are protected from unreasonable rates permits us totally to exempt small systems ... from rate regulation." Id. at para 463. The language of the statute itself indicates that the Commission cannot entirely exempt small systems from rate regulation. First, as noted in the Commission's discussion in the Rate Order, Section 623(b)(1) of the Communications Act requires that the Commission's rules protect subscribers of "any" cable system not subject to effective competition. Thus, absent a statutory exemption, the regulatory requirements of the law apply to all systems, including small systems. Second, the statute expressly addresses special regulatory treatment of small systems in Section 623(i), but that Section authorizes the Commission only to "reduce" the administrative burdens and cost of compliance for small systems. Use of the term "reduce" implies that some amount of regulatory burden, although lessened, would remain. Similarly, because it is the "cost of compliance" that is to be reduced, it is apparent that some compliance is intended. If Congress had intended to exempt small systems entirely, or afford discretion to eliminate all burdens on such systems, it would have so stated.[304] Accordingly, our efforts to reduce regulatory burdens and cost for small systems may not include complete exemption.

223. We also reject the "reasonable net revenue" test proposed by the Coalition and CATA.[305] This test would

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at 1; CATA Petition for Reconsideration at 5.

[304] The legislative history also supports the conclusion that small systems may not be totally exempted from rate regulation. For instance, during floor debate a sponsor of the legislation, Representative Slattery, stated that "we are not talking about exempting ... the small systems from regulation." 138 Cong. Rec. H6526 (daily ed. July 23, 1992). In addition, the dissenting views appended to the House Report states:

> Rather than exempt small systems from the economic and administrative burdens of rate and equipment [regulations], the bill merely directs the FCC to take into account the administrative burdens on small systems in adopting such regulations.

H.R. Rep. No. 628, 102d Cong., 2d Sess. 187 (1992).

[305] CATA Petition for Reconsideration at 7; Coalition of Small System Operators Petition for Reconsideration at 10-13.

exempt those systems with a net income margin[306] of less than 15.5% from rate regulation. We believe that there is no dependable connection between this proposed test of profitability and a presumption that a small system's rates are reasonable. There are simply too many factors that can affect the gross revenue and net revenue calculations that are not necessarily related to reasonableness of rates. The expenses of the system may be unusually high for reasons that would normally not be acceptable in cost based rate regulation. For instance, the system may be using accelerated depreciation or the system may have unreasonable salary or other expenses paid to owners. Moreover, we foresee numerous practical problems in implementing such an approach. For example, we are concerned that efforts to verify the legitimacy of "net revenue" figures, to obtain additional information and to provide safeguards sufficient to maintain the integrity of a net revenue test would add such complexity as to defeat the purpose of regulatory simplification for small systems. Accordingly, we do not believe that this option is an appropriate way to reduce the regulatory burdens on small systems.

224. Arizona would require (rather than merely encourage) multiple franchise authorities regulating a single small system to jointly file for rate regulation certification.[307] While we continue to encourage such joint certification, we do not believe that it is appropriate to override individual franchising authorities' prerogatives to make their own rate-setting determinations.

225. Finally, CATA proposes that we delay small system rate regulation pending a study of the effects of the benchmark, and that small systems be permitted to charge a rate within some percentage of the average national charge.[308] We do not believe that the proposal to allow small systems to charge a rate within some percentage of an average national charge has merit. Such a proposal would merely create an alternative benchmark rate and would not necessarily be any simpler to administer. We also do not intend to delay rate regulation for small systems while we study the effect of our rate regulations on other systems.

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[306] These commenters would calculate net income by subtracting operating expenses, interest payments, and depreciation from gross revenues.

[307] Arizona Cable Television Association _et_. _al_. Petition for Reconsideration at 8-9.

[308] CATA Petition for Reconsideration at 7-8.

We note that we have already provided a transition mechanism for small operators. Moreover, by adopting the new rate-setting methodology and the average equipment cost approaches contained herein, we provide an easy, less burdensome means for small systems to comply with rate regulation. Any further delay in rate regulation for small systems -- other than those provided in our transition rules -- would be unnecessary.

2. Headend vs. Franchise Area Definition of Small Systems

226. In response to the Stay Order/Further Notice, many commenters argue that the definition of a small system should be changed from a "headend" to a "franchise area" basis. They contend that the franchise area definition would be consistent with the definition of cable system for other rate regulation purposes because regulated rates are determined on a franchise area basis. They also contend that the use of a franchise area definition will not place artificial barriers on the technical integration of different franchise areas with a single headend.[309] Some commenters state that they have stopped such technical integration and consolidation because of the concern that they would lose their small system classification.[310]

227. We continue to believe that determining small system size based on a system's principal headend, including any other headends or microwave receive sites that are technically integrated to the system's principal headend, best harmonizes our small system rule with most of our existing regulations on cable system size. For example, the existing 1,000 subscriber exemptions in the network non-duplication and public inspection file rules are based on a system's headend rather than franchise area.[311] To use a franchise area definition would result in some segments of a single integrated cable operation receiving rate treatment different from other segments of the same operation. Moreover, if we changed the definition of small system to a franchise area basis, we would significantly increase the number of instances in which an operator would qualify for regulatory relief. However, many of these "small systems" would merely be franchise areas with 1,000 or fewer

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[309] Medium-Sized Operators Group Comments at 6-7; Coalition of Small System Operators Comments at 7-9.

[310] Mullin, Rhyne, Emmons and Topel Comments at 2.

[311] See 47 C.F.R. Sections 76.95, 76.305.

subscribers that were part of integrated cable systems serving much larger numbers of subscribers. Additionally, we continue to believe that the benefits from consolidated operation in a technically integrated headend sufficiently outweigh the benefits of classification as a small system so that future consolidation and improvements will not be unduly inhibited.

3. Termination of Rate Regulation Stay for Small Systems

228. As indicated, in the Stay Order/Further Notice, we stayed rate regulation of small systems until we further addressed small system issues on reconsideration. We have now completed our evaluation of small system issues. In addition, small systems have been afforded a substantial period of time to prepare for rate regulation, and we see no reason to delay for their subscribers the benefits of rate regulation. Therefore, we will terminate the stay for small systems as of May 15, 1994, the effective date of the rules adopted herein. Local authorities may provide initial notices of regulation to small systems as of that date, and the Commission will accept newly filed complaints concerning cable programming services tiers provided by small systems as of that date.[312] Small systems must then submit a rate justification (or otherwise file a permitted response, such as a written notification that it intends to use the streamlined rate reduction process) within the 30 days prescribed in our rules.[313] In addition, the statutory 180-

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[312] Local authorities may have provided initial notices of regulation to operators during the stay and the Commission has accepted complaints for cable programming services tiers provided by small system since September 1, 1993. These notices and complaints will be considered as having been made or filed, respectively, as of May 15, 1994, the effective date of our new rules.

[313] See Rate Order at paras. 116, 356. Small system operators previously subject to the stay may obtain an extension of time to establish compliance with rate regulations if they can show that timely compliance would result in severe economic hardship. Requests for extension of time should be addressed to the local franchising authority concerning rates for the basic service rates and to the Commission concerning rates for a cable programming services tier. Possible circumstances showing severe economic harm might be based on prior commitments with regard to programming contracts or actual plans in progress for significant improvements to its plant and equipment, or an unusually severe impact on the financial condition of the company that could be

day window for filing complaints concerning rates for cable programming services tiers in effect on May 15, 1994 will commence running on that date for small systems.[314]

III. Fourth Report and Order

A. Introduction

229. In this Fourth Report and Order, we adopt a methodology for adjusting capped rates when channels are added to, or deleted from, a tier of regulated cable service. We also decline to modify our benchmark requirements to account for system upgrades initiated or completed shortly before the onset of rate regulation of cable service.[315]

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caused by rate reductions. However, an extension of time to comply will not toll the effective date of rate regulation for small systems or eliminate refund liability for rates that exceed permitted levels after the effective date of our rules.

[314] Section 623(c)(1)(B) of the Communications Act, 47 U.S.C. Section 543(c)(1)(B), requires the Commission to provide procedures for the receipt, consideration and resolution of complaints from any subscriber, local franchising authority or other state or local government entity concerning unreasonable rates for cable programming services. Section 623(c)(3) of the Communications Act, 47 U.S.C. Section 543(c)(3), provides that except during the 180 day period following the effective date of rate regulations complaints may be filed only after a reasonable period following a rate increase. In the Rate Order, the Commission determined that that period would be forty-five days. Our rate regulations concerning small systems have not gone into effect. Rate Order at para. 333. Therefore, the 180 day statutory period for filing complaints concerning rates, other than for rate increases, will commence running on the effective date of our revised rules.

[315] We solicited comment on this issue in the Third Further NPRM in this proceeding. First Order on Reconsideration, Second Rate Order, and Third Further Notice of Proposed Rulemaking ("Third Further NPRM"), MM Docket No. 92-266, FCC 93-428 (released Aug. 27, 1993), 58 FR 46737 (Sept. 2, 1993). The Third Further NPRM also solicited comment on what limitations should be adopted to govern operator discretion to select between the benchmark and cost-of-service approaches for purposes of setting initial regulated rates. That issue was addressed in the Third Report and Order, MM Docket No. 92-266, 8 FCC Rcd 8444 (1993), which required cable systems to choose a consistent approach (benchmark or cost-of-service for all tiers). The Third Further

230. In our April, 1993 Rate Order, we provided that cable operators may pass through, after setting their initial regulated rates for a tier, any increases in programming costs for regulated services that exceeded inflation.[316] The Rate Order did not, however, specify how the benchmark approach should be used to determine rates when channels were added or deleted to regulated service tiers. In the Third Further NPRM, we thus sought comment on how we should adjust capped rates to reflect channel additions or deletions. We now adopt in this decision a methodology for adjusting rates in these circumstances. This approach permits operators to adjust their rates by specified per-channel amounts that apply to channels that are added, dropped, or moved from one tier to another. As such, the methodology is an easy way to adjust capped rates that will facilitate programming changes. It also permits operators to recover fully programming expenses.

B. Adjustments to Capped Rates for Addition and Deletion of Channels

1. Background

231. In the Third Further NPRM, we sought comment on what methodology should be adopted for applying the benchmark system to adjust capped rates when channels are added or deleted from regulated tiers.[317] We sought comment first on the regulatory goals that should guide our adoption of a methodology for addition and deletion of channels.[318] We tentatively concluded that the methodology we develop should achieve the objectives of protecting consumers from unreasonable rates while assuring the continued growth of the cable industry and the additional services that it can provide to subscribers.

NPRM also solicited comment on whether we should establish external cost treatment for the costs of upgrades required by local franchise authorities. Third Further NPRM at paras. 153-154.

[316] Rate Order at para. 257. As discussed, para. 174 supra., we are modifying in this Order the methodology for calculating external costs and inflation.

[317] A list of commenters responding to issues raised in the Third Further NPRM is included in Appendix A.

[318] Third Further NPRM at para. 136.

232. We then solicited comment on three possible methodologies for adjusting capped rates when adding or deleting channels from a particular regulated tier. Under the first proposed method, the new charge for the tier would consist of the sum of: (1) the current permitted charge for the tier, and (2) a charge calculated by multiplying the benchmark rate by the number of new channels on the tier. Under this approach, the declining rate per channel reflected in the benchmark would be applied only to additional channels. The per channel charge for existing channels would not be adjusted downward to reflect the benchmark curve. We tentatively concluded that this approach should not be adopted because it would permit significantly higher rates; because it could not be readily used for setting rates when channels are deleted; and because it would permit tier pricing above the economies of scale observed in our Competitive Survey and reflected in the benchmark system.[319]

233. Under the second methodology proposed in the Third Further NPRM, the new permitted rate for a regulated tier when channels are added or deleted would be the benchmark per-channel rate multiplied by the new number of channels on the tier. This approach would assure that the benchmark curve is fully reflected in rates because the charge for the tier would be calculated by applying the benchmark rate to all channels on the tier.

234. In addition, by applying the benchmark per channel rate to calculate new rates instead of the operator's permitted per channel rate as calculated using FCC Form 393, this approach would bring systems whose rates were above the benchmark down to the benchmark when they added or deleted channels. At the same time, however, it would allow systems whose regulated rates were below the benchmark to bring those rates up to the benchmark simply by adding or deleting channels from regulated service. We tentatively concluded that this approach should not be adopted because it would create substantial disincentives for cable operators with rates above the benchmark to add channels and because it could create undue incentives for systems with below benchmark rates to add channels, permitting substantially increased rates for such operators.[320]

235. We tentatively concluded in the Third Further NPRM

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[319] Third Further NPRM at para. 137.

[320] Third Further NPRM at para 138.

that we should adopt a third methodology, which we termed the "parallel track" approach. Under this approach, programming costs would be removed from an operator's permitted charge per tier. The remaining charge would then be adjusted to reflect the proportionate increase or decrease observed in the benchmark curve based on the new number of channels offered across all regulated tiers. The new level of programming expense for the tier would then be added back to the adjusted tier charge to obtain the new charge for the tier. We stated in the Third Further NPRM that this approach incorporates the downward sloping benchmark curve that we observe when operators in an unregulated environment added channels and thus passes on to subscribers the efficiencies and economies of scale reflected in the benchmark rates.

2. Regulatory Goals

236. Commenters expressing a view on this issue broadly agree with our proposed goals for the methodology for adjusting capped rates when channels are added or deleted from a regulated tier.[321] They state, for example, that the Commission should seek to preserve incentives for cable operators to provide additional programming services to consumers, while protecting consumers from unreasonable rates.[322] Several commenters suggested additional goals,[323] such as furthering increased diversity and local origination of programming[324] and promoting administrative ease.[325]

237. We conclude that our methodology for adjusting capped rates when channels are added or deleted from regulated tiers should be consistent with, and further implement, our general approach for regulation of cable service rates. Thus, our regulations governing adjustments to capped rates should preserve the competitive rates produced by our requirements for setting initial regulated rates, since rates closer to competitive levels will best

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[321] See, e.g., Disney Comments at 2; Viacom Reply Comments at 2-3; GTE Reply Comments at 2.

[322] See, e.g., Disney Comments at 2.

[323] See, e.g., Liberty Comments at 2-3; NATOA Comments at 14-15.

[324] Liberty Comments at 2-3. See, e.g., Viacom Reply Comments at 2-3; Liberty Reply Comments at 3-4.

[325] See NATOA Comments at 14-15.

serve consumers. Moreover, lower rates for goods and services can in many cases increase the quantities demanded, and can further increase output as suppliers seek to meet that demand. Thus, maintaining rates at reasonable levels as channels are added or deleted from regulated cable service will benefit the public by making available to consumers a greater quantity and range of services at lower prices.

238. In addition, we believe that the cable industry can, and should, continue to grow and provide new and additional services to subscribers. In particular, operators should be given incentives to participate fully in the development of an advanced telecommunications infrastructure. Accordingly, a goal of our "going-forward" methodology is to allow cable operators to grow and develop new facilities and services, including new and innovative regulated programming services. This goal is fully consistent with the views of commenters that our methodology should promote a diversity of programming. Our methodology should also seek to further the statutory goal of reducing administrative burdens on subscribers, operators, and regulators. We explain below how the going-forward methodology we adopt today meets these stated goals.

3. The Going-Forward Methodology

a. Comments

239. Several cable operators support the first alternative, arguing that it would provide the greatest incentives for operators to add channels because it permits the highest rates.[326] All operators expressing a view oppose the second approach arguing that it would provide significant disincentives for systems above the benchmark to add additional programming to regulated tiers.[327] Many operators support adopting the third alternative, the third alternative, provided certain modifications were made.[328]

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[326] See, e.g., Time Warner Entertainment Comments at 2-3 (Sept. 30, 1993); Viacom International, Inc. Comments at ii (Sept. 30, 1993).

[327] See, e.g., Viacom International, Inc. Comments at 7 (Sept. 30, 1993); NCTA Comments at 2 (Sept. 30, 1993).

[328] See, e.g., Austin, Texas, et. al. Comments at 8-9 (Sept. 30, 1993); Falcon Cable TV Comments at 2 (Sept. 30, 1993); TCI Comments at 1 (Sept. 30, 1993); Tele-Media Entertainment Co. Comments at 1-2 (Sept. 30, 1993).

Several operators, however, oppose it.[329] They argue that the benchmark formula, and the underlying data on which it is based, are flawed and that, consequently, the formula cannot be incorporated into a methodology to set rates when channels are added or deleted from regulated tiers.[330]

240. A number of programmers oppose the first alternative on the ground that it would discourage cable systems from purchasing expensive programming because, as described in the Third Further NPRM, it would not take into account actual programming costs.[331] Programmers also strongly opposed the second option, arguing that it would provide significant disincentives for systems above the benchmark to add additional programming to regulated tiers.[332] The majority of programmers expressing support for one of the alternatives favor the third alternative, although many proposed modifications while expressing their support.[333] Programmers favor the third proposed methodology because in their view it reduces the disincentives for operators to purchase high quality programming contained in other approaches.[334]

241. A number of franchising authorities also support the third alternative.[335] Other franchising authorities oppose it because they believe that it would be difficult to

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329 See, e.g., Time Warner Entertainment Comments at 3-4 (Sept. 30, 1993).

330 See Time Warner Entertainment Comments at 3-4 (Sept. 30, 1993).

331 See, e.g., NBC Comments at 3 (Sept. 30, 1993); Liberty Media Corp. Comments at 7 (Sept. 30, 1993).

332 See, e.g., Liberty Media Corp. Comments at 4 (Sept. 30, 1993); NBC Comments at 2-3 (Sept. 30, 1993).

333 See, e.g., The Disney Channel Comments at 2-4 (Sept. 30, 1993); NBC Comments at 3-5 (Sept. 30, 1993).

334 See, e.g., ARC Comments at 6-7 (Sept. 30, 1993); The Disney Channel at 2-4 (Sept. 30, 1993); NBC Comments at 3-4 (Sept 30, 1993).

335 See, e.g., MCATC Comments at 3 (Sept. 30, 1993); Coalition Reply Comments at 9 (Oct. 7, 1993)(favor for the short term).

administer.[336] They support the second alternative because they view it as producing lower rates and because they believe it would be simpler to administer.[337] A number of commenters favor permitting a mark-up on programming expense, arguing that this would encourage investment in new programming.[338]

b. Discussion

242. In addition to revealing a significant competitive differential that we will use to implement our revised benchmark approach, our Competitive Survey of industry rates as of September 30, 1992, established that, on average, charges per channel decrease as the number of channels offered by a system increases. This downward "curve" in per-channel rates may well reflect economies of scope and scale in the provision of regulated cable service. Using this curve in developing a going-forward methodology would benefit consumers by assuring that they receive the reduction in per channel rates that apparently arises as cable systems grow and add channels. At the same time, because the curve is based on observed per channel rates, we believe that a methodology that adjusts capped rates in accordance with this curve will permit operators to continue to invest in the provision of cable service. Thus, incorporation of this curve in our methodology will help achieve our goals of protecting consumers and permitting operators to respond to marketplace forces for provision of new services.

243. We emphasize that cable operators have failed to provide concrete cost or other factual information showing that the observed pattern of rates voluntarily established by the industry in an unregulated environment will not permit recovery of costs when new channels are added, including through facilities upgrades.[339] For the most part,

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[336] See NATOA Comments at 14-16 (Sept. 30, 1993).

[337] See NATOA Comments at 14-16 (Sept. 30, 1993).

[338] See, e.g., Discovery Communications Inc. Comments at 8-10 (Sept. 30, 1993); Viacom Comments at 9-13 (Sept. 30, 1993); The Disney Channel Comments at 5-7 (Sept. 30, 1993); NBC Comments at 2-5 (Sept. 30, 1993); Joint Parties Comments at 9-11.

[339] For example, Liberty Media claims that the efficiency factor reflected in the benchmark is inappropriate for situations when channels are added, but does not give hard evidence as to why this is so. Liberty Media Comments at 8-11 (Sept. 30, 1993).

they merely offer generalized allegations that do no more than point out that the benchmark rate decreases on a per channel basis as the number of channels increases.[340] Accordingly, we will adopt a methodology for adjusting capped rates that incorporates the downward curve of per-channel rates observed in our Competitive Survey. We also emphasize that those operators who believe that the rates determined under our new benchmark approach and the going-forward methodology we adopt, are inadequate when channels are added may make a cost-of-service showing in order to attempt to justify a higher rate.

244. The third alternative proposed in the <u>Third</u>

Continental includes a one page exhibit showing upgrade costs in certain circumstances, but no data supporting the numbers or conclusions in the exhibit. Continental Comments at 14-15 (Sept. 30, 1993). Medium Operators contend, citing an Ernst & Young report, that while in some cases the benchmark captures the capital costs for providing video signals, on other occasions it does not. Medium-Sized Operators Comments at 3-4 (Aug. 4, 1993). However, Medium Operators do not provide adequate evidence to demonstrate that it is unreasonable to assume that benchmark rates permit operators to recover cost when channels are added. In fact, a number of Medium Operators' arguments, conclusions, and the applicability and methodology of the Ernst & Young study are questioned and disputed by the Coalition and a Jay Smith study attached as an exhibit to their comments. Austin, Texas, <u>et</u>. <u>al</u>. Comments at 1-8 and Exhibit A at 2-4 (Sept. 30, 1993). Cable Operators merely assert that operators adding channels incur greater costs and realize fewer efficiencies than operators that initially built a system with the same number of total channels as the upgraded system. Cablevision Industries Corp. Comments at 3-4 (Sept. 30, 1993).

[340] For these reasons, we are not persuaded that our going-forward methodology will be inadequate unless we provide for external cost treatment for associated upgrade or capital expenditures. We have previously rejected external cost treatment for upgrades. <u>Rate Order</u>, para. 256, n.608. In addition, we have separately provided a mechanism to adjust capped rates to recover the costs of upgrades. <u>See Cost Proceeding</u>. In that decision, we provided for a streamlined cost-of-service showing to permit operators to adjust rates by the net change in costs involved in upgrades. This streamlined showing will also be available to adjust rates for costs of upgrades required by local franchise authorities. Accordingly, we will not establish, or further consider, in this proceeding external cost treatment for upgrades generally, or for upgrades required by local franchise authorities.

Further NPRM is fully compatible with our revised benchmark formula and approach for setting regulated rates.[341] For the same reasons that our statistical and other improvements to the benchmark formula better estimate the competitive differential, the revised benchmark formula more accurately captures the curve of declining per channel rates as the total number of offered regulated channels increases.[342] Therefore, we can employ our new benchmark formula in a going-forward methodology, and it should permit operators to recover costs of providing additional channels while passing on to consumers the per-channel savings observed in our Competitive Survey.

245. Under the third alternative proposed in the Third Further NPRM, operators would subtract programming expenses from the permitted charge for each tier to establish a residual rate component for the tier. This is consistent with the requirements that we are adopting on further reconsideration for calculating all external costs and inflation adjustments.[343] This treatment will achieve identical results as the method specified in the Rate Order but will be simpler to administer. At the same time, the operator will be able to fully recover in going-forward rate calculations the actual level of programming expense incurred. This approach will assure that operators may respond to demand for programming and recover their costs when adding channels. Accordingly, we believe that of the

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[341] The first and second approaches for a going-forward methodology discussed in the Third Further NPRM presume identification of specific competitive rates such as those specified in the benchmark adopted in the Rate Order that would be used to set rates for some or all channels when channels are added to, or deleted from, a regulated tier. Thus, these approaches would use specific prescribed rates for calculating tier prices when channels are added. However, under our revised approach for setting regulated rates we have chosen not to identify specific competitive rates and instead require all regulated operators to reduce rates by the competitive differential, with the exception of those systems that qualify for transition treatment. Therefore, the first and second approaches are not compatible with our revised benchmark approach and cannot be adopted.

[342] In the Technical Appendix we explain and justify our new benchmark formula. We therefore reject arguments that our going-forward methodology cannot be based on that formula or underlying data.

[343] See para. 174-177, supra.